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COMMONWEALTH OF VIRGINIA

STATE CORPORATION COMMISSION

AT RICHMOND, JANUARY 14, 1999

COMMONWEALTH OF VIRGINIA, ex rel.

DAVID W. DESMOND, et al.

v.

CASE NO. PUE970544

UNITED WATER VIRGINIA, INC.

FINAL ORDER

By notice dated May 22, 1997, United Water Virginia, Inc., ("UWV" or "the Company") notified its customers and the Commission's Division of Energy Regulation pursuant to the Small Water or Sewer Public Utility Act (§§ 56-265.13:1 et seq. of the Code of Virginia) of its intent to increase its water rates effective July 5, 1997, for a revenue increase of \$128,375.

The Company proposed to increase its bimonthly minimum rate for water service from \$61.32 to \$67.50. The proposed minimum includes 5,000 gallons of water usage, a decrease of 1,000 gallons from that currently allowed. The Company also proposed to increase the charge for usage in excess of the minimum allowance from \$3.13 to \$4.32 per 1,000 gallons and to include in its tariff an \$80.00 charge for reconnection after normal business hours.

By June 16, 1997, the Commission had received a petition signed by 255 of the Company's customers requesting a hearing on the matter. On June 23, 1997, the Commission entered a Preliminary Order suspending the proposed rate increase through October 19, 1997, and making such increase interim and subject to refund, with interest, thereafter.

By order entered on October 6, 1997, the Commission scheduled a hearing for March 10, 1998; assigned the matter to a Hearing Examiner; and established a procedural schedule for the filing of pleadings, testimony and exhibits. Pursuant to the Hearing Examiner's Ruling entered on January 27, 1998, the procedural schedule and the date for the evidentiary hearing were extended to April 9, 1998.

The original hearing date was retained for the purpose of receiving the testimony of public witnesses. Ten witnesses appeared at that hearing and testified in opposition to the proposed rate increase. In their testimony, the witnesses expressed, among other things, concern regarding the impact the proposed increase would have on customers with fixed incomes; the Company's failure to make promised major capital improvements; the proposed decrease in the minimum usage allowance; and the inclusion of certain Company operating expenses in the Company's cost of service.

The evidentiary hearing was held on the appointed day before Hearing Examiner Michael D. Thomas. Counsel appearing were Donald G. Owens and Walton Hill for the Company; Marta B. Curtis and William H. Chambliss for the Commission's Staff; and Joseph E. Blackburn for the Protestants.¹

The majority of issues dealt with accounting matters. The Company and Staff disagreed on the proper calculation of the Company's revenues, salaries, and wages; the appropriate treatment for actuarial study costs, other post-employment benefits ("OPEBs"); rate case expense; and the proper treatment for expenses associated with insurance other than group. The Company and Staff also disagreed on the proper treatment of expenses associated with the funding of a system-wide integrated financial management system ("IFMS"), the costs of the Company's 1998 internal audit and Staff's parent company debt adjustment; and the proper calculation of gross receipts taxes, deferred federal income taxes, and rate base. The Protestants disagreed with the Company and Staff regarding the calculation of the Company's working capital. Although not at issue in this proceeding, Staff recommended that the Company begin to amortize contributions-in-aid of construction ("CIAC") through December 31, 1997, and book deferred federal income tax expense

¹ Several individuals, civic associations, and property owners associations participated as Protestants in the proceeding.

in accordance with the Uniform System of Accounts for Class C Water Utilities and reflect the 35 percent consolidated tax rate on the books of the utility.

There was also a rate design issue and an issue regarding Staff's proposed revision to certain language in the Company's rules and regulations of service. The Company opposed Staff's recommendation for the inclusion of a third rate block of \$6.00 per 1,000 gallons for all usage over 15,000 gallons and its recommendation that UWV amend its tariff to reflect the actual cost of the service connection, plus any applicable taxes.²

The Company did not object to Staff's recommendation to include a \$10.00 per month charge for seasonal customers disconnected from the system. Neither did the Company object to Staff's recommendations to modify Rule No. 8 to allow 10 days' written notice before initiating service disconnection; to eliminate Rule No. 10(B) relating to landlord/tenant billing responsibility; to delete certain language from Rule No. 16(E); or to modify Rule No. 11 to reflect water bills due within 30 days of the billing date and disconnection after such time with proper written notice. Staff did not object to the Company's proposed reconnection charge.

² Staff recommended, in the alternative, that the Company cease collecting income tax gross-up until such time as it obtains a ruling from the Internal Revenue Service ("IRS") on the applicability of 26 U.S.C. § 118, as amended on June 12, 1996, to connection fees for water and sewer companies.

There were also capital structure, cost of capital, and cost of equity issues. The Company, Staff and the Protestants disagreed on the proper capital structure for the Company. The Company proposed using the capital structure of its parent, United Waterworks ("UWW"), as of December 31, 1996; Staff proposed using UWW's capital structure updated to December 31, 1997; and Protestants proposed using the consolidated capital corporate structure of United Water Resources, Inc. ("UWR"), which is UWW's parent and UWR's ultimate parent.

On September 30, 1998, the Hearing Examiner issued his Report. In his Report, he found that:

(1) The use of a test year ending December 30, 1996, was reasonable;

(2) The rates proposed by the Company are excessive. In lieu thereof, the Commission should direct the Company to set rates to produce revenues of \$96,497;

(3) The Company's customer growth was 22 as of September 30, 1997, and its average use per customer during the test year was 38.33 thousand gallons;

(4) A three-year average, without adjustment, should be used to calculate the Company's overtime and summer help expenses, and all payroll expense accrued in the test year should be included in the Company's 1996 per books payroll expense;

(5) The Commission should disallow the cost of the Virginia-specific actuarial study in the Company's rates;

(6) The Commission should accept the Staff's position with respect to disallowance of deferred SFAS 106 costs in rates and deduction of the unfunded portion of its SFAS 106 costs from rate base;

(7) The Company's requested rate case expense of \$111,255³ appears reasonable under the circumstances of this case;

(8) The Commission should accept the Company's proposed insurance other than group expense based on test year level of expenses;

(9) The Commission should reject the Company's proposed \$14,560 increase in IFMS expense and should accept the test year expense of \$11,807, as recommended by Staff;

(10) The Company's proposed expense for the 1998 internal audit should be accepted;

(11) The Staff's proposed parent company debt adjustment should be rejected;

(12) The Company's proposed expense of \$47,879 for deferred federal income tax expense should be accepted;

(13) The Company's utility plant in service for this proceeding should be \$3,500,936;

³ Although the Examiner references \$111,155 as rate case expenses, the Examiner acknowledges on p. 18 of his Report that the true level of requested rate case expenses is \$111,255.

(14) Staff's adjustment to annualize accumulated depreciation appears reasonable;

(15) The use of UWW's capital structure, updated to December 31, 1997, as recommended by the Staff, appears reasonable;

(16) The Staff's recommended return on equity range of 9.60% to 10.60% with rates set at the 10.10% midpoint of the range appears reasonable;

(17) The tariff and rate design modifications recommended by the Staff should be adopted by the Commission with the exception of the modification adopting the Company's proposed reduction in the minimum bimonthly usage allowance; and

(18) The Company's and Staff's calculation of total working capital, based on 1/9 of O & M expense for cash working capital plus a 13 month average for material and supplies, is reasonable.

The Examiner recommended that the Commission enter an order that adopts the findings in his Report; grants the Company an increase in gross annual revenues of \$96,497; directs the prompt refund of amounts collected under interim rates in excess of the rate increase found reasonable; and dismisses this case from the Commission's docket of active cases.

In his discussion of the tariff issues, the Examiner recommended that the Commission require the Company to submit a

request to the IRS regarding the applicability of 26 U.S.C. § 118 to connection fees for water and sewer companies. He also recommended that the Commission direct its Staff to review UWW's capital structure on an annual basis to determine whether the Commission should continue using that capital structure for ratemaking purposes.

On October 14, 1998, the Protestants filed comments on the Hearing Examiner's Report. In their comments, the Protestants took exception to the findings of the Hearing Examiner with regard to the proper capital structure for UWV, the calculation of working capital, and the inclusion of rate case expense.

It was the Protestants' position that the capital structure of UWR should be used for determining UWV's rates. Protestants noted that UWR is the ultimate source of capital for the entire consolidated system and has the ability to manipulate the capital structure of its subsidiary, UWW. It was also Protestants' position that the allowance for total working capital should be limited to either \$65,954, which is one-ninth of operations and maintenance ("O & M") expense for the pro forma period, or to the expense for materials and supplies. Protestants stated that it was improper, pursuant to the Rules Implementing the Small Water or Sewer Public Utility Act,⁴ to

⁴ Commonwealth of Virginia, ex rel. State Corporation Commission Ex Parte: In the matter of adopting rules implementing the Small Water or Sewer Public Utility Act, Case No. PUE 870037, 1987 S.C.C. Ann. Rept. 291.

include both one-ninth of O & M and materials and supplies expense in rate base.

Protestants' objected to the inclusion of any legal expense in rate case expense stating that there was no evidence in the record to support such expense. Protestants also stated that rate case expense associated with the use of AUS Consultants ("AUS") should be reduced since the use of both AUS and United Water Management and Services Company ("Management Company") resulted in a duplication of efforts. Protestants noted that AUS' fees were greater than those of Management Company and that incomplete interrogatory responses by AUS resulted in the propounding of further interrogatories. Protestants also stated that the only fee that should be allowed for AUS' cost of capital witness was that for the witness' appearance at the hearing since that witness' prepared testimony was previously prepared for a proceeding before another public service commission. In addition, Protestants requested oral argument on the issues discussed in their comments.

On October 15, 1998, the Company filed comments on the Hearing Examiner's Report. In its comments, the Company took exception to the Examiner's findings regarding the accrual for payroll expense, the deduction from rate base of the SFAS 106 expenses deferred since 1994, and the disallowance of a portion of the IFMS expense.

It was the Company's position that it was improper to make an accrual adjustment for payroll expense for the pro forma period because the pro forma period already represented a full 365-day year. The Company maintained that it was erroneous to deduct from rate base the full amount of SFAS 106 costs deferred since 1994. Rather, the Company stated, \$47,857 of deferred costs not recovered in expense should not be used to reduce the Company's rate base. The Company also maintained that the full amount, or \$26,367, paid to support the IFMS should be recoverable in rates as the evidence showed that such amount "represents the ongoing level of outside service required to monitor and maintain work stations and servers associated with these new systems."

The Company also took issue with the Examiner's finding that the Commission should direct the Company to submit a request to the IRS regarding the applicability of 26 U.S.C. § 118 to connection fees of water or sewer companies. In support of its position, the Company noted that there was a high cost associated with the filing of such a request and that the IRS would not respond to any such request pending the promulgation of regulations addressing the matter.

Staff filed its comments that same day. In its comments, Staff took exception to the Examiner's findings with regard to rate case expense and Staff's parent debt adjustment. Staff

also took exception to the Examiner's recommendation that Staff be directed to review annually UWW's capital structure to determine whether such structure should continue to be used for ratemaking purposes.

Staff maintained that the Company had not met its burden of proof as to the reasonableness of the \$111,255 of rate case expense. Staff questioned the reasonableness of hiring AUS as outside consultants and the reasonableness of AUS' rates considering duplication of its work by in-house personnel. Staff noted that the majority of the work of those consultants and of outside counsel could have easily been performed by the Management Company's in-house personnel.

Staff also maintained that the Examiner improperly rejected its parent debt adjustment solely because the entity filing the taxes was UWV's "grandparent" rather than its parent. Staff noted that its adjustment is not unlike those previously accepted by the Commission. In such cases there was a tax benefit, enjoyed by a holding or owning company funded, in part, by ratepayers of an operating utility subsidiary of that company providing service in Virginia. Staff noted that, in this instance, there was a nexus between UWV and the debt and equity of UWR which finances UWV through its investment in UWW. Staff also noted that, like that of other cases, UWV's rates make possible the interest deduction realized by an upstream owner.

With regard to annual capital structures monitoring, Staff believed it more practical to review such capital structures in future rate cases rather than annually. Staff noted that the information necessary for such review was not readily available since neither UWV, UWW nor UWR was required to make annual filings. Moreover, Staff noted, there was no mechanism short of a formal proceeding to make changes in a company's ratemaking capital structure.

On October 30, 1998, the Company, by counsel, filed a Motion for Leave to Make Reply to Protestants' Comments on the Hearing Examiner's Report. In support of its motion, the Company stated that, although there was no provision in the Commission's Rules of Practice and Procedure for replies to the comments of other parties, a limited reply was necessary to address "certain statements, inferences or allegations made by the Protestants for the first time in their comments filed on October 14, 1998." The Company requested that, if its motion were granted, the Commission accept and consider the reply attached to that motion.

NOW THE COMMISSION, having considered the record, the Examiner's Report and the comments thereto, is of the opinion and finds that the Examiner's findings and recommendations should be adopted with the exception of those modified herein. We will modify the Examiner's findings and recommendations with

respect to overtime expense, insurance other than group expense, deferred federal income tax expense, rate case expense, Staff's parent debt adjustment, and the requirement that the Company request a ruling from the IRS. We will clarify our position with respect to the Examiner's findings associated with internal audit expense and the appropriate rate design for this proceeding. We will not disturb the Examiner's finding with respect to capital structure except to remove the annual review requirement.

We will accept Staff's adjustments to overtime expense and insurance other than group expense. Staff's use of a three-year average excluding the hours of the employee that switched to exempt status for calculating overtime expense is most representative of the future. We disagree that removal of such hours, before averaging, understates the Company's going-forward expense. To the contrary, removal of such non-recurring expense is necessary to determine such expense on a going-forward basis.

Staff's use of a rate year for calculating insurance other than group expense should be accepted based on the record. The record reveals that use of such data reflects cost reductions effective January 1, 1998, and is more appropriate than the use of a test year level of expense that would require ratepayers to continue to fund reduced expenses at the formerly higher level. Acceptance of a rate year in this instance is not inconsistent

with our acceptance of other methodologies for other expenses as different methodologies are appropriate for determining the proper level of expense on a going-forward basis.

We will accept Staff's adjustment for deferred federal income taxes with regard to the book/tax timing difference for depreciation expense. The record reveals that Staff based its adjustment on the Company's response to an on-site Audit Request which showed that only a portion of the normalized book/tax difference was deferred. Once Staff presented evidence that it relied on such data, the burden shifted to Company to produce evidence that its calculation of taxes was correct. The Company has not met its burden of producing evidence. There appears to be no explanation on the record as to the reasons for Company's assertion that its calculation is correct.

We will allow the Company to recover its rate case expense amortized over five years. In the Company's last rate case we had concerns about the level of the Company's rate case expenses. We continue to have grave concerns about the level of such expenses incurred by UWV, which it seeks to recover from its customers. Specifically, in this case the Company seeks to recover \$111,255 for a requested rate increase of \$128,375.

In the Company's last rate case, we expressed our concern with the reasonableness of rate case expense when services were performed by its affiliate, and we noted that such expenses

appeared to be excessive.⁵ In this case, the Company's case was prepared by outside consultants in addition to its affiliate's participation, but without any resulting economy of expenditure from the 1992 case. The Company is cautioned and directed to plan and budget more carefully with its next application.

We are not reducing the requested amount, primarily, because the record does not permit quantification of that portion that should be eliminated and it is not disputed that recovery of some level of such expense is warranted. Rather, we have concluded to allow the Company to recover its requested rate case expense, but amortized over a five-year period, rather than over three years as the Company had requested. While this extended amortization will ameliorate somewhat the rate effect of this expense, it is also consistent with the period between UWV's latest rate filings and is therefore in line with the Commission's usual practice on the issue.

As stated, we are concerned about these expenses. While in this instance outside consultants rather than affiliated personnel were used to prepare the majority of the filing, the anticipated and resulting expenses were similar to those rejected, in part, in UWV's last case. The Staff complained that use of the consultants resulted in "doubling up" of certain

⁵ Commonwealth of Virginia ex rel. Bruce M. Berry, et al. v. Virginia Suburban Water Company, Case No. PUE920015, 1993 S.C.C. Ann. Rept. 252.

expenses and requested we disallow all or some of the expense as unreasonable.

UWV was not responsible for the retention of the expert witnesses (or outside counsel) who appeared on its behalf, and the record does not indicate that the Company was given a voice in their retention. The witnesses were, in fact, hired by the Management Company, which is UWV's affiliate. The Management Company retained AUS Consultants to assist in rate filings in several different jurisdictions, according to documents introduced during the hearing. Exhibit GSP-14.

The Commission recognizes, as also noted by the Examiner, that there is acrimony between the Company and its customers, and that the Company contends it was obligated to incur additional legal expense in defending its application against the aggressions of the Protestants and the Staff. Rate cases are not unique to UWV, are seldom uncontested, and the Commission expects a company coming before it to defend its position. Nevertheless, other utilities are able to operate without the level of rate case expense experienced by UWV.

Having said all this, the Commission cannot find that all the rate case expenses were imprudently incurred. The record is not sufficiently developed to permit precise quantification of that portion of the Company's expenses that are excessive, but the Company, and particularly its affiliate, Management Company,

should note that we will not countenance another filing such as this. In future filings, UWV and Management Company will be expected to manage these expenses with vigor and to keep them reasonable.

We will accept Staff's adjustment reducing federal income tax expense to recognize the benefit of tax savings funded by ratepayers. We disagree with the Examiner that such adjustment should be rejected because there is no nexus between Virginia ratepayers and the tax benefit derived from the interest deduction of UWR. It makes no difference as to the identity of the upstream entity that benefits from the tax benefits funded by ratepayers. We believe that such adjustment is consistent with prior decisions⁶ and is equitable since the interest deduction of UWR is funded in part by Virginia ratepayers.

We will accept the Examiner's findings and recommendations with respect to internal audit expense. We will allow the test year level of 1995 audit expense for the pro forma period. The three-year amortization period for such timing of the Company's internal should continue until the frequency of the Company's audits has been determined.

While we agree with the Examiner's findings and recommendations with regard to rate design, we have a concern

⁶ Application of Virginia-American Water Company, Case No. PUE950003, 1997 S.C.C. Ann. Rept. 333. Application of GTE South Incorporated, Case No. PUC950019, 1997 S.C.C. Ann. Rept. 216.

that needs to be addressed because the recommended increase in the proposed minimum bimonthly usage will result in a loss in incremental usage revenues. We will, therefore, allow the Company to offset that loss by applying a corresponding revenue increase to the minimum charge.

We agree with the Examiner that the Company should continue to collect the tax gross-up on connection fees, subject to refund. We will not, however, require the Company to request a ruling from the IRS on the applicability of federal income tax to water connection fees. While the applicability of federal income tax to water connections is a small issue in Virginia, we expect the Company to take all necessary action to protect the interests of its Virginia customers.

We will deny Protestants' request for oral argument. The issues of concern to Protestants have been fully litigated and argument presented both in brief and comment on the Examiner's Report. We will allow the Company's Motion for Leave to Make Reply to Protestants' Comments on such Report. We note, however, that the Reply did not change our conclusions in this proceeding. Accordingly,

IT IS ORDERED THAT:

(1) The Protestants' motion requesting oral argument be, and hereby is, denied.

(2) The Company's Motion for Leave to Make Reply to Protestants' Comments on the Hearing Examiner's Report be, and hereby is, granted.

(3) The findings and recommendations of the Hearing Examiner, as modified herein, are hereby adopted.

(4) The Company shall implement Staff's booking recommendations as detailed in Staff witness Gilmour's testimony.

(5) Consistent with the above referenced modifications, the Company shall be granted an increase in gross annual revenues of \$59,082.

(6) The difference between the final increase granted herein and that proposed by the Company shall be applied to the minimum charge.

(7) Within thirty (30) days from the date of this Order, the Company shall file with the Division of Energy Regulation rates, rules, and regulations of service as modified herein.

(8) On or before May 3, 1999, UWV shall refund, with interest as directed below, all revenues collected from the application of the interim rates which were effective for service beginning October 20, 1997, to the extent that such revenues exceeded the revenues which would have been produced by the rates approved herein. The Company shall file with the

Staff tariff sheets reflecting the reinstatement of its permanent rates.

(9) Interest upon the ordered refunds shall be computed from the date payment of each bimonthly bill was due during the interim period until the date refunds are made, at an average prime rate for each calendar quarter. The applicable average prime rate for each calendar quarter shall be the arithmetic mean, to the nearest one-hundredth of one percent, of the prime rate values published in the Federal Reserve Bulletin, or in the Federal Reserve's Selected Interest Rates ("Selected Interest Rates") (Statistical Release G.13), for the three months of the preceding calendar quarter.

(10) The interest required to be paid shall be compounded quarterly.

(11) The refunds ordered in Paragraph 7 above, may be accomplished by credit to the appropriate customer's account for current customers (each such refund category being shown separately on each customer's bill). Refunds to former customers shall be made by a check to the last known address of such customers when the refund amount is \$1 or more. UWV may offset the credit or refund to the extent no dispute exists regarding the outstanding balances of its current customers, or customers who are no longer on its system. To the extent that outstanding balances of such customers are disputed, no offset

shall be permitted for the disputed portion. UWV may retain refunds owed to former customers when such refund amount is less than \$1; however, UWV will prepare and maintain a list detailing each of the former accounts for which refunds are less than \$1, and in the event such former customers contact UWV and request refunds, such refunds shall be made promptly. All unclaimed refunds shall be handled in accordance with § 55-210.6:2 of the Code of Virginia.

(12) On or before June 1, 1999, UWV shall file with the Staff a document showing that all refunds have been lawfully made pursuant to this Order and itemizing the cost of the refund and accounts charged. Such itemization of costs shall include, inter alia, computer costs, and the personnel-hours, associated salaries and cost for verifying and correcting the refund methodology and developing the computer program.

(13) UWV shall bear all costs of the refunding directed in this Order.

(14) There being nothing further to come before the Commission, this matter shall be removed from the docket and the papers placed in the file for ended causes.